goals of universal service by helping to provide affordable telecommunications services to an ever-expanding base of American citizens. Accordingly, elimination of rate of return based regulatory distortions and other steps to improve and purify the current price cap regulatory structure will only have positive implications for universal service.

It is also important, however, to recognize the general limitations of **any** price cap system in addressing universal service concerns. Price cap regulation is not intended to and cannot be a substitute for public assistance. No changes in the LEC price cap plan are likely to significantly increase the penetration level of customers whose family income is less than $5,000 per year.[29/] Thus, if the public interest demands that all Americans -- regardless of location or means -- have access to telecommunications, then the Commission must undertake a comprehensive review of existing universal service mechanisms to determine the extent to which they can be made more effective.[30/] BellSouth intends to work vigorously with the FCC and the state commissions on any initiatives aimed at increasing penetration levels for those segments of society that significantly lag behind the national average.[31/]

Baseline Issue 2: Composition of Baskets and Bands

> *Whether the rules relating to the LEC price cap baskets and bands should be revised. Specifically, commenters should address whether current or revised price cap baskets and bands would reflect expected levels of competition for LEC interstate services, or other relevant common characteristics. For example, we request information and comment on whether differences in pricing behavior within and among baskets evidences different levels of competition.*

29/ See Notice at 11, ¶ 29.

30/ It should be noted, though, that other factors besides the price of basic telephone service significantly affect telephone penetration levels.

31/ In response to Baseline Issue 12, BellSouth has urged the Commission to begin immediately a proceeding addressing Universal Service issues. See infra at 73.

It is appropriate for the Commission, as part of its baseline review of LEC price caps, to revise price cap baskets and bands. BellSouth's proposed modifications are not dramatic departures from the current basket and banding requirements. BellSouth believes, however, that the proposed improvements will enhance considerably the performance and efficiency of the price cap plan, and will better achieve the Commission's price cap policy goals, including the realization of increased efficiency, reasonable nondiscriminatory rates, and minimal regulation.[32/]

As the Commission recognized when it adopted price regulation for the LECs, baskets and bands are methods of restricting the degree of pricing flexibility that would otherwise be permitted under a pure system of price regulation.[33/] While a single basket structure with no bands would maximize economic efficiency, the baskets and bands originally adopted by the Commission were intended to provide certain protections to ratepayers without stifling the efficiency objectives that are at the heart of the price cap rules.[34/]

In the LEC Price Cap Order, the Commission acknowledged the importance of minimizing the number of baskets and indices that apply to LEC services but nevertheless adopted a restrictive, conservative approach to LEC pricing flexibility.[35/] The regulatory complexity of the LEC price cap plan's basket and banding structure is no longer warranted in view of the Commission's experience with price cap regulation and the regulatory

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32/ See Notice at 18, ¶ 41.

33/ LEC Price Cap Order, 5 FCC Rcd at 6810, ¶ 198.

34/ See id. at 6810-11, ¶ 198. Specifically, the Commission's goal in employing a system of baskets and bands is to permit incremental changes in price that will reward LECs that become more productive and efficient without subjecting ratepayers to precipitous changes in the prices for LEC services and without enabling LECs to disadvantage one class of ratepayers to the benefit of another class. Id.; see Notice at 17, ¶ 38.

35/ LEC Price Cap Order, 5 FCC Rcd at 6812, ¶ 209.

flexibility that is necessary to achieve economic efficiency and consumer benefit. The current basket and banding structure, with its numerous service categories and subindices, is far more restrictive than is necessary to ensure reasonable prices, and unnecessarily sacrifices efficiency and incentives for regulatory constraints.

The purpose of price regulation is to emulate as closely as possible the competitive market.[36/] In order to achieve this goal, LECs ought to be afforded the same pricing flexibility that is found in competitive markets irrespective of the level of competition for LEC services.[37/] Indeed, in the absence of full competition, the Commission's priority must be to ensure that its regulatory approach functions as a proxy for the market in securing just and reasonable rates for consumers. As a regulatory technique, price regulation not only is a transition mechanism to fully competitive access markets, but also encompasses the "zone of reasonableness" within which rates should fall. The relevant zone "is precisely the same as that within which firms operating in competitive markets exercise public discretion."[38/]

36/ Notice at 13, ¶ 33. Indeed, as the Commission has noted, "the lower prices and improved services generated by price caps should continue to benefit consumers, in much the same manner as the competitive markets price caps seeks to replicate."

37/ As Haring and Rohlfs observe, "[i]t makes no sense to argue that firms can be afforded the flexibility to price efficiently within a properly designed zone of reasonableness only if there is competition -- obviously regulated firms should be afforded the same flexibility -- if they are not, they cannot mimic competitive performance. Alternatively, insisting that regulated firms price inefficiently to afford new entrants profitable opportunities for expansion invites overexpansion and creates a moral hazard." Haring/Rohlfs Report at 5-6 (footnote omitted) (emphasis in original).

38/ Id. at 7. Specifically, as Haring and Rohlfs explain, the economically appropriate zone of reasonableness for pricing flexibility "is delimited by pricing floors and ceilings defined in terms of average incremental (/marginal) costs and stand-alone costs, respectively." Id. at 12. Although competition will affect the prices that firms actually select, the zone of reasonableness for pricing flexibility is itself invariant with respect to the degree of competition. The zone of reasonableness "is defined in terms of norms based on competitive behavior under idealized conditions of competitive perfection." Id. at 7. Under the existing regulatory regime, tariffing regulations and price cap ceilings applied to a number of separate service baskets provide the fundamental means for guaranteeing that rates fall within a zone of reasonableness. Id. at 14.

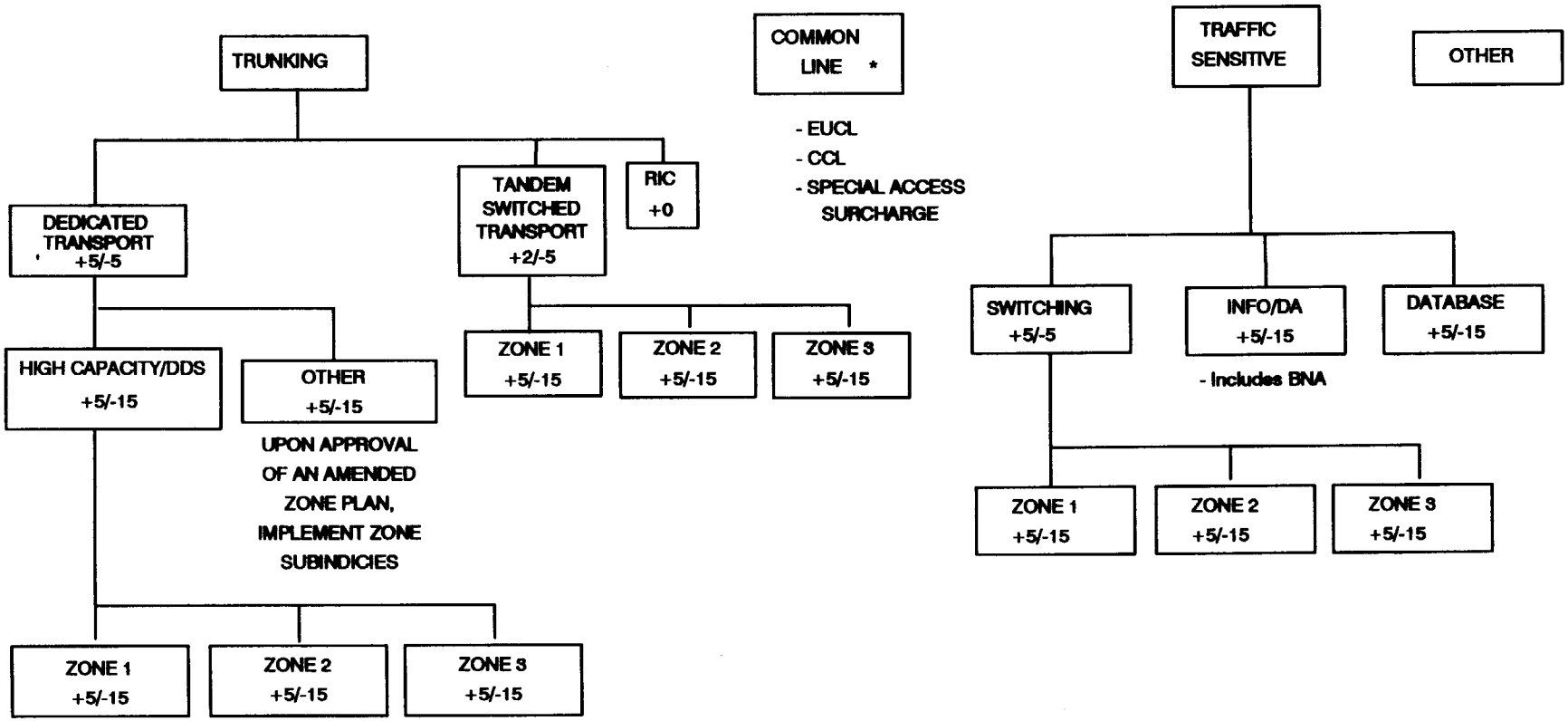
The Commission currently uses tariffing regulations and price cap ceilings applied to a number of separate service baskets as the fundamental means for ensuring that rates fall within a zone of reasonableness.[39/] The essence of BellSouth's pricing flexibility proposals is to eliminate those price cap constraints that serve no legitimate regulatory purpose and that only interfere with the efficiencies and incentives that price caps are intended to create. As competition flourishes, additional modifications to the price cap rules will be warranted. BellSouth discusses such modifications in response to the transition issues identified in the Notice. The modifications proposed here, however, should be made, not because of the emergence of competition, but because they are needed to ensure that the price cap plan has the appropriate attributes to achieve the Commission's goals. Levels of competition, actual or expected, do not bear upon the immediate need to make changes to the existing basket and banding requirements of the price cap rules.

BellSouth's proposed baseline modifications build upon the recent changes in the basket structure adopted by the Commission in light of the local transport restructure.[40/] The following chart summarizes BellSouth's recommended basket and banding structure:

39/ Id. at 14.

40/ See In the Matter of Transport Rate Structure and Pricing, Second Report and Order, CC Docket No. 91-213 (released Jan. 31, 1994) ("Transport Order").

PROPOSED BASELINE BASKET STRUCTURE



* The Commission should consider alternative CCL recovery mechanisms including zone pricing with no more than 3 zones (+5, -15) and flat rate recovery.

As the preceding chart reflects, BellSouth proposes no change to the basket composition for the common line, traffic sensitive or trunking baskets. BellSouth recommends, however, that the interexchange basket be renamed to "Other." The "Other" basket would include not only interexchange services, such as interstate intraLATA, but also would include all new services which cannot be appropriately assigned to the common line, traffic sensitive or trunking baskets.

BellSouth's proposal also builds upon the service categories in the current rules. Under the current rules, only two of the four baskets have service categories -- trunking and traffic sensitive. Neither the common line nor the Other (currently interexchange) baskets are subject to service category banding. While BellSouth suggests limited modifications to the service categories in the trunking and traffic sensitive baskets, these modifications reflect reasonable efficiency and incentive improvements.

1. **Trunking**

With respect to the trunking basket, the current rules require LECs to maintain six service categories: (1) voice grade entrance facilities, voice grade direct-trunked transport, voice grade dedicated signalling transport; voice grade special access; WATS special access, metallic special access, and telegraph special access services; (2) Audio and Video services; (3) High Capacity and Digital Data Service (DDS); (4) Wideband Data and Wideband Analog services; (5) Tandem-switched transport; and (6) the Interconnection charge.[41/] BellSouth proposes that the six service categories be reduced to three. The current Tandem-switched transport and Interconnection service categories, including the banding limits, would remain unchanged. The other four service categories would be combined into a Dedicated Transport service category with an upper and lower banding limit

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41/ See Notice at 17 n.46; Transport Order at ¶¶ 12, 21-23 & Appendix B, § 61.42(e)(2) (trunking basket rule change). Within the high capacity DDS service category are the two sub-categories for (1) DS1 special access and DS1 flat-rated transport and (2) DS3 special access and DS3 flat-rated transport.

of 5%. The Dedicated Transport service category would have two subcategories: High Capacity (including DDS) and Other. Each of the two subcategories would have an upper pricing limit of 5% and a lower pricing limit of 15%.

The above service category and subcategory modifications will enhance the efficiency of the price cap plan and at the same time provide more than sufficient constraints to address any regulatory concerns of the Commission. There is no purpose achieved by retaining service categories for each type of dedicated service, particularly when -- with the exception of high capacity services -- the other types of dedicated services are either in decline or dormant.[42/]

The only significant dedicated transport services are for high capacity services and voice grade services. To the extent that the Commission believes that these services should continue to have separate pricing constraints, BellSouth's baseline proposal creates two subcategories -- high capacity/DDS and other. These two subcategories maintain the regulatory check against precipitous price decreases for high capacity services being offset by increases in the price for voice grade services. Unlike the current rules, however, there would be no subindices for DS1 or DS3 services. The DS1 subindex was originally created because of concerns regarding the strategic pricing of DS1 services relative to voice grade services.[43/] While in the mid-1980's, rate alignment of DS1 and voice-grade service prices was in fact a ratemaking approach followed by some LECs, this approach has not been used in the recent past -- certainly not since price cap regulation took effect. Given the extended

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42/ For example, wideband services are available only on an ICB basis and are therefore excluded from price caps. The last time a wideband circuit was ordered was in 1988. Thus, forcing LECs to maintain a separate service category for wideband for price management purposes is irrational. Likewise, audio and video access services represent an inconsequential volume of business -- less than one-half of one percent of special access transport revenue -- that would be virtually unmeasurable compared to all dedicated transport revenue.

43/ See LEC Price Cap Order, 5 FCC Rcd at 6788, ¶ 15.

period of time that has elapsed since strategic pricing of DS1 services has been employed, strategic pricing cannot continue as a justification for maintaining a DS1 subindex. More fundamentally, even if concerns regarding strategic pricing remain, the two subcategories proposed by BellSouth effectively constrain a LEC's ability to strategically price its DS1 services.[44/]

The DS3 subindex was created because the Commission had little experience with DS3 services. At the time that the Commission adopted price cap regulation for the LECs, DS3 services, as general offerings, had just been introduced. Indeed, in the LEC Price Cap Order, the Commission noted that it was in the process of investigating DS3 rates.[45/] Thus, the Commission pursued an ultra-conservative approach and imposed banding limits on DS3 price changes. That environment has changed considerably. The Commission, LECs and consumers have now had ample experience with DS3 services. Simply put, the uncertainty which led the Commission to establish a DS3 subindex no longer pertains.

For each of the subcategories, BellSouth proposes that the lower pricing limit be increased from 5% to 15%. The expanded pricing bands obviously provide greater pricing flexibility, particularly in the downward direction. Such additional flexibility will likely inure to the benefit of consumers in the form of innovative pricing plans and lower prices in general. There is no public interest reason that would warrant narrower pricing limits.

44/ It should also be noted that market conditions have changed substantially from the time the Commission expressed concern with DS1 strategic pricing. It is not at all clear that strategic pricing of DS1 services would present any public interest concerns in the current market environment even if it were to occur.

45/ LEC Price Cap Order, 5 FCC Rcd at 6813, ¶ 223.

The current rules already permit zone pricing for the existing service categories in the trunking basket. BellSouth's proposal would continue to permit zone pricing for services included in the trunking basket. BellSouth proposes, however, that the lower price limit for zones be increased from 10% to 15%. This represents a modest change from existing rules but is nonetheless an important one. The minimal additional pricing flexibility provides the LECs a greater opportunity to price their services in a manner that would be expected in a competitive marketplace. Because a central objective of price cap regulation is to replicate the competitive market, the additional pricing flexibility is fully consistent with Commission objectives.

2. **Traffic Sensitive**

The traffic sensitive basket currently has four service categories: (1) local switching; (2) information; (3) database access; and (4) billing name and address (BNA).[46/] Of these four service categories, only two were part of the original price cap plan. The database and BNA service categories were recently added to the Traffic Sensitive basket for the purpose of price managing two new services offered by the LECs.[47/] The database and BNA service categories, however, are not categories of services at all but instead represent service-specific banding requirements that run counter to the fundamental principles of price cap regulation. Like the sharing mechanism and certain other features of the current price cap plan, these requirements are additional examples of the ill-advised retention of a rate-of-return style of regulation that has unnecessarily removed positive competitive incentives from the price cap plan and replaced them with embedded pricing inefficiencies.

46/ Notice at 16, n. 45; see Transport Order at 8, ¶ 12.

47/ See In the Matter of Provision of Access for 800 Service, Second Report and Order, 8 FCC Rcd 807 (1993) ("800 Database Access Order"); In the Matter of Policies and Rules Concerning Local Exchange Carrier Validation and Billing Information for Joint Use Calling Cards, Second Report and Order, 8 FCC Rcd 4478 (1993).

The database service category is illustrative of the disincentives and distortions that have crept into the price cap rules. The database service category was recently created by the Commission to accommodate the LECs' offering of 800 database access.[48/] This was the only service included in the category.[49/] The Commission also established a subcategory for the 800 database vertical features, thereby creating a separate banding requirement for these options. The Commission's rationale for this action was that its standard "for creating service categories is to establish one for each Part 69 rate element. Since we establish a new 800 data base service element and sub-elements in this order, we will establish a new data base service category."[50/]

The Part 69 access elements, however, were never intended to be the criteria for the establishment of price cap service categories.[51/] Indeed, when it implemented price caps, the Commission recognized that the incentives it was attempting to establish could easily be stifled by restrictive banding requirements, and specifically rejected a call that a separate service category be established for 800 database. Instead, the Commission found

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48/ 800 database access was a restructure of an existing access service, 800 NXX. 800 NXX was already subject to price caps, and routed 800 calls to interexchange carriers on the basis of six digit screening. 800 database access screened 800 calls on the basis of ten digits thereby allowing for 800 number portability. At the same time 800 NXX service was restructured, new optional 800 vertical services were filed by the LECs.

49/ It should be noted that 800 database service was not the first database service. The first database service was the Line Information Database (LIDB) service. LIDB was introduced without the Commission modifying its price cap rules, and was merged into existing price cap indices. See Local Exchange Carrier Line Information Database, 7 FCC Rcd 525 (1991). LIDB currently is in the trunking basket.

50/ 800 Database Access Order, 8 FCC Rcd at 912.

51/ Thus, for example, although special access is the access element contained in Part 69, special access currently is nowhere identified in the basket or banding structure of the price cap rules. In BellSouth's view, the fact that special access is not a basket or category for price cap purposes is appropriate. Part 69 was created long before price cap regulation and the Part 69 elements can hardly be viewed as delimiting service boundaries for price cap purposes.

that "ratepayers will be adequately protected by the three categories": local switching, local transport, and information.[52/]

The recent Commission actions casting aside the LEC Price Cap Order's original determination regarding an 800 Database service category and creating a subcategory for 800 Vertical Features illustrate the need for regulatory reform and reinvigoration of price cap goals. BellSouth believes that the Commission must adjust its current service category and banding structure for the traffic sensitive basket to correct these conceptual disconnects from the price cap plan.

First, BellSouth proposes that the number of service categories be reduced to three. Specifically, the BNA service category should be eliminated and collapsed into the information service category. The reconstituted information service category would thus contain a family of services involving customer information that is ancillary to the origination or completion of an interstate call.

Second, the Commission should enlarge the scope of the database service category to include LIDB as well as all database services developed in the future. If a database service category is to have any validity, it must be defined in such a way to encompass a large enough group of services to make price management under price caps potentially efficient. In addition, the subcategory for 800 vertical services should be eliminated. That particular banding requirement is the functional equivalent of rate element banding, and cannot be reconciled with the objectives of incentive regulation.[53/]

52/ LEC Price Cap Order, 5 FCC Rcd at 6813, ¶ 217.

53/ Creation of this subcategory for 800 vertical services illustrates retreat from another of the Commission's principles regarding price cap banding -- that banding requirements should not be unnecessarily burdensome. In the LEC Price Cap Order, the Commission did not adopt rate element banding. Yet, that is precisely the effect of the subcategory for 800 vertical features. These features are options associated with the basic database service. They cannot be obtained from the LEC independent of the basic 800 database service. Indeed, the Commission made clear that only the purchaser of the basic database service could order the vertical features. Thus, the vertical features are nothing more than rate elements associated with the basic service -- but rate elements for which the

These proposed modifications to the service category structure of the traffic sensitive basket, standing alone, are insufficient to remedy past distortions and to improve price cap performance dramatically. Additional flexibility in the banding limits is necessary to achieve a more efficient basket structure. To this end, BellSouth proposes that zone pricing be extended to the switched service category. Switching costs like transport costs vary with the traffic density. Therefore, zone pricing would permit more economic pricing and improve overall efficiency of the price cap plan. The upper and lower pricing limits for the switching zones would be the same as those in the trunking basket.

The zone pricing concept is not easily adaptable to the other traffic sensitive service categories. Nevertheless, additional pricing flexibility should be provided. BellSouth proposes that the lower pricing limits for these service categories be increased to 15%. Increasing the lower pricing limits for these service categories enables consumers to benefit from price decreases that otherwise could not occur because of price cap constraints. On the other hand, these service categories are sufficiently narrow to prevent price decreases from being offset by large price increases.

3. Conclusions Regarding Basket and Banding Proposals

While the BellSouth proposals described above are modest, they would measurably improve the performance and attendant benefits of price caps. They would better align price caps as a transition mechanism to a fully competitive access market. The modifications proposed by BellSouth would afford LECs a greater opportunity to price their services in the same manner as a firm operating in an effectively competitive market. Thus, the price cap plan would more closely replicate competitive market outcomes -- a stated objective of the Commission.

Commission has established special banding limitations.

Failure to make at least these modest modifications to the price cap plan will create or perpetuate price regulations that in effect will compel LECs to price services at economically inefficient levels. Such a result subverts the role of price caps as a transition mechanism to competition because the Commission can never discover how competitive the market is. Forcing LECs to engage in inefficient pricing merely creates a regulatory price "umbrella" under which new entrants will seek to expand their operations. The ability of LEC competitors to exploit artificially inflated profit opportunities will provide little information regarding the true emergence of sustained market-based competition.

The objective of the Commission in revising the basket and banding requirements of the price cap rules should be to assure that the rules permit a structure of prices which replicates a competitive market. It is not the presence of competition that mandates pricing flexibility, but instead a recognition that regulation (i.e., price caps) like competition is a means of producing economically efficient price structures.

Baseline Issue 3: Changes in Productivity Factors or Rate Levels

The price cap plan rewards or penalizes carriers whose performance exceeds or falls short of the price cap index ("PCI"), a benchmark that is adjusted each year. The yearly adjustment of the PCI is based on a measure of inflation that embodies economy-wide productivity gains and price changes, the Gross National Product Price Index ("GNP-PI"), minus a productivity factor.[54/] This productivity factor in turn reflects the amount by which LEC productivity historically has exceeded that of the economy as a whole, plus a consumer productivity dividend ("CPD") of 0.5%. In the LEC Price Cap Order, the Commission mandated a PCI that includes a 3.3% or an optional 4.3% productivity offset

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54/ The PCI may also be further adjusted for exogenous cost changes. See Notice at 19, ¶ 43; infra at 54-57.

each year.[55/] Noting that some LECs have experienced relatively higher earnings on average under price caps, the Commission has requested comment on three baseline issues dealing with possible revisions of the LEC productivity offset. These three issues are addressed in sequence below.

Baseline Issue 3a:

Whether the productivity factor used to compute the LEC price cap indices should be changed; in addition, or in the alternative, whether a onetime change in the LEC's price cap index should be required. If a rate reduction were required, commenters should discuss how such a reduction should be distributed among price cap baskets and service categories. As a further alternative, whether the Commission should adopt a mechanism which would adjust the plan to reflect changes in interest rates. Commenters should discuss how such a mechanism would operate, including, for example, what deviations in interest rates would trigger the adjustment mechanism. Commenters should address how the option they advocate would preserve or improve price cap incentives and assure just and reasonable rates.

The Commission first requests comment on several alternative approaches to revising the LEC productivity factors, including proposed additions or adjustments that would reflect changes in interest rates. There is no justification for increasing the LEC productivity offset at this time. To the contrary, the evidence suggests that the LEC productivity offset should be significantly reduced.

In the LEC Price Cap Order, the Commission noted as it weighed competing short-term and long-term productivity studies that it was compelled to exercise its judgment to resolve the disparity in the historical record regarding the proper baseline productivity for LECs subject to price caps. The Commission chose the 3.3% productivity offset acknowledging that "historical studies cannot assure that the future, in which the price cap

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55/ LEC Price Cap Order, 5 FCC Rcd 6796. If a LEC elects the 4.3 percent productivity offset, the LEC lowers its rates an additional 1 percent permanently but may retain a greater portion of its profits (only for one year) if it can increase its productivity. Id. at 6796, 6799; see also LEC Price Cap Reconsideration Order, 6 FCC Rcd at 2642. Interexchange services for LECs are capped based upon the 3 percent productivity offset adopted and recently reaffirmed to cap AT&T's services. See AT&T Price Cap Review Order, 8 Rcd FCC Rcd 6968, 6971, ¶ 22.

plan will be applied, will not differ from the past."[56] Recent studies appear to confirm the Commission's observation. As described in connection with Baseline Issue 3c infra, the recent Total Factor Productivity (TFP) study performed by Christensen Associates on behalf of the United States Telephone Association demonstrates that the baseline productivity offset for price caps LECs initially chosen by the Commission in fact has proven to be too high. Measuring from the time of the AT&T divesture (1984) through the first two years of price caps (1992), the Christensen study calculates that the growth differential between the LECs and the most comprehensive TFP measure published by the Bureau of Labor Statistics has been **1.7 percent**. Even adding in the CPD, the Christensen result demonstrates that the LEC productivity offset should be reduced over a full percentage point from the Commission's 1990 estimate.

The appropriateness of a reduction in the LEC productivity offset is reinforced by the likelihood that as competition continues to emerge rapidly in the local exchange market the aggregate productivity growth of the price cap LECs in the coming years will be slower than the historical industry average reflected in the current price cap plan.[57] Specific reasons for this expected slowdown in LEC productivity growth relative to the rest of the economy include:

- **Reduction in LEC Economies of Density** --

56/ LEC Price Cap Order, 5 FCC Rcd at 6796, ¶ 78.

57/ In assessing the status and trends in competition facing LECs, Strategic Policy Research has observed:

> LECs already face some competition now. In some areas, competition is quite intense now and in other areas competition is growing rapidly. During the next ten years, competition in local exchange markets will likely far outpace the early growth of long distance competition. Not only are barriers to entry being removed at Federal and state levels, but regulators are also (unwisely) handicapping LECs by limiting their ability to respond to competition.

SPR Vision Paper, supra note 17, at 5 (footnotes omitted).

The telephone industry in general and the local exchange market in particular historically have possessed significant economies of density that were an important part of the rapid output and productivity growth of the pre-divestiture Bell system.[58/] Economies of density are present when average cost falls as more output is provided over a network of fixed size, and are especially present for the LECs in high-margin, high density metropolitan markets.[59/] As regulatory initiatives and technological innovation continue to spur competitive entry into these high density urban markets, incumbent LECs increasingly will incur competitive losses.[60/] As the LECs lose some customers in these areas, they will also lose some of their previously-achieved economies of density, and this factor in turn will reduce productivity gains.

- **Tapering of Downsizing as Method of Realizing Efficiency and Productivity Gains** --

LECs were able to capture relatively "easy" productivity gains in the first three years under price caps through workforce reductions that the Commission itself anticipated would be an initial consequence of adopting the price cap plan.[61/] As LEC

58/ See Christensen Productivity Study at 14 (Chapter 2, "The Relationship Between Output Growth and Productivity Growth"); Douglas W. Caves and Laurits R. Christensen, "The Importance of Scale, Capacity Utilization, and Density in Explaining Interindustry Differences in Productivity Growth," The Logistics and Transportation Review, Vol. 24, No. 1 (Spring 1984), at 26.

59/ Economies of density are often calculated using variables such as the number of central offices and the number of customers per square mile. The greater efficiencies achieved as the concentration of the number of customers per square mile increases can be attributed to economies of density.

60/ As the FCC staff noted in its working paper on access charge reform, competitive service areas "tend to be the dense metropolitan areas in which the LECs have deployed network facilities that enable significant productivity gains." FCC Access Reform Task Force, Federal Perspectives on Access Reform: A Staff Analysis (April 30, 1993), at 51 ("Access Reform Staff Analysis"). The staff has recognized that LEC competitors have incentives to enter markets "that have historically provided the funding for assistance and contribution flows, namely, high volume business users in metropolitan areas where LEC rates have traditionally been higher than their costs." Id. at 54. For example, as of a year ago, competitive access providers ("CAPs") were providing alternative access service in approximately 50 major metropolitan areas, and recent surveys indicate that 62 percent of larger business users use CAPs for at least some access service. SPR Vision Paper at 6 (citations omitted).

61/ Notice at 13, ¶ 33.

operations reach competitively efficient levels, incremental productivity gains will be less obtainable through workforce reductions.

- **IXC Absorption of Access Charge Reductions** --

LEC productivity growth depends in part on the extent to which the efficiencies achieved in local networks are reflected in lower rates to end users. To the extent that LEC access charge reductions to IXCs are not passed along to end users, this reduces the stimulation to minutes of use ("MOUs") and LEC productivity increases that otherwise would have occurred. Thus, to the extent that the operation of the AT&T price cap program permits access charge reductions to be absorbed without commensurate reductions in long distance rates, this will in the future continue to reduce expected LEC productivity gains derived from growth in MOUs.

- **Continuation of Regulatory Constraints** --

Incumbent LECs are handicapped in their ability to respond to emerging competition from new market entrants by numerous regulatory requirements. For example, LECs are explicitly prohibited from offering volume and term discounts until competitors reach a certain size. They are also hamstrung by tariff filing requirements; geographic rate averaging requirements; public policy decisions that have established prices not based upon economic cost; prohibitions against pricing on an individual contract basis; outdated rate structures; and a protracted waiver and appeals process.

The numerous regulatory constraints to which LECs are subject again ultimately will contribute to reduced LEC output and efficiency growth as customers are lost to competitors. Furthermore, this problem will be exacerbated significantly if the Commission continues to dilute productivity incentives by retaining the earnings sharing mechanism currently featured in the LEC price cap plan.

- **Transition to Competition and Eroding Validity of the Historical Productivity Offset** --

In the LEC Price Cap Order, the Commission observed that in broad terms, the PCI (which includes the productivity offset) is the first step in reviewing whether a carrier's tariff filings qualify for streamlined review.[62/] As competition continues to emerge in local exchange markets, the Commission increasingly will identify and transition more and more competitive services out of price cap regulation and subject them to streamlined review in recognition of the truism that in effectively competitive markets, market forces best further the goals of the Communications Act.[63/] The transition and introduction of new services outside of price regulation means that the productivity gains from services still subject to price cap regulation can be expected to be considerably lower than the achieved industry-wide historical productivity growth upon which the current price cap productivity offset is based. This is because the historical productivity offset used in the PCI reflects the effects of tremendous productivity gains made possible by the introduction of past technology advances, while services that remain subject to price cap regulation will tend to be basic, core services using existing technology. Indeed, as competition continues to expand, a fundamental concern with the removal of competitive services from price regulation is the degree to which LECs' remaining regulated services will be able to achieve the level of productivity implied in the productivity offset. If the LEC productivity offset

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62/ LEC Price Cap Order, 5 FCC Rcd at 6792, ¶ 49.

63/ The Commission has found the reason for this conclusion to be "quite simple":

> [C]ompetitive forces best allocate society's resources, encourage innovation and efficiencies, and generally maximize benefits to consumers. Indeed, while limited government regulation of functionally competitive markets may sometimes be appropriate to further important social goals, such as universal service, unduly strict regulation of rates in competitive markets is generally not only superfluous, but harmful to the public interest.

In re Competition in the Interexchange Marketplace, Notice of Proposed Rule Making, Docket No. 90-132 (1990), at ¶ 97.

remains too high, the increasing downward pressure on price unaccompanied by offsetting productivity achievements could mean that it will become increasingly unprofitable for LECs to offer regulated services.

With respect to the issue of whether the LEC price cap plan should be adjusted to reflect changes in interest rates, BellSouth believes that such an adjustment is neither necessary nor appropriate. Part of the rationale for price caps -- indeed, one of its most attractive features -- is that it separates prices from rate of return. Once cost-based regulation has been rejected, it simply makes no sense to fine-tune the price cap plan to account for specific factors that might affect the determination of an appropriate rate of return. As NERA has observed, many factors that affect the cost of operation and anticipated revenues can change, e.g., labor rates may grow faster than anticipated; the prices for network components can change; competition may reduce the revenues of incumbents more rapidly than costs; and volumes may change in unanticipated ways.[64/] Under a system of incentive regulation, management agrees to take the risk for such volatility, meaning that financial results will be better when events go better than anticipated, and they will be worse when expectations are not met.[65/] Adjusting the price cap plan to reflect interest rate changes anomalously re-introduces the cost of debt capital as a separate consideration in the price cap formula in a manner that simply has no place in a system of price regulation.[66/]

64/ See NERA Study at 26.

65/ See id. at 27-28.

66/ Id. In addition, under generally accepted accounting principles (GAAP), the Commission has required LECs to absorb the cost of refinancing debt in the year incurred. The Commission has reasoned that the carriers would recoup these costs over the life of the refinanced debt in the form of lower interest rates. See, e.g., In the Matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Memorandum Opinion and Order, 6 FCC Rcd 7193 (1991) (observing that "the lower interest rates allow the carriers to lower their embedded debt

Furthermore, changes in interest rates are already reflected in the inflation component of the price cap adjustment formula, the GNP-PI. A major factor driving changes in interest rates is expected inflation. Recent rises in interest rates are being directly attributed to fears of renewed inflation on Wall Street and in the financial press. Since the GNP-PI adjusts the price cap index to reflect inflation directly, a separate adjustment to the price cap formula to reflect changes in interest rates would "double count" the same variable.[67]

Baseline Issue 3b:

Are the price cap LECs profit levels reasonable under the current LEC price cap plan in light of the price cap goal that higher profits are intended to be the reward for attaining increased efficiencies?

Although it is true that LEC profits have increased under price caps, as the Commission has suggested, this phenomenon is precisely what is to be expected under a price cap regime.[68] Given that the increase in LEC profits has also been accompanied by a significant decline in interstate access rates (in spite of an overall inflation in the economy of 11.6%),[69] as well as LEC pricing that has been consistently at or below applicable PCIs,

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costs by refinancing outstanding high-priced debt"). If the Commission now adjusts the price cap index to reflect the LEC's lower interest cost, it will (1) eliminate the ability of the LECs to recover these costs and (2) eliminate the incentive for LECs to refinance higher cost debt. Therefore, the Commission should continue to treat interest rate changes as endogenous under the LEC price cap plan.

67/ See NERA Study at 25 (observing that if "one factor price (e.g. the price of capital services) changes because of changes in interest rates, much of the impact on the regulated firm would be captured in the GNP-PI, because all firms in the economy face the same economic conditions that would have caused a secular increase or decrease in capital costs".

68/ As the Notice observes, the driving incentive under price caps is profitability: "The LECs are rewarded with higher profits if they achieve productivity growth above the target, and are penalized with lower profits if they fall short." Notice at 20, ¶ 45.

69/ Overall, LEC interstate access rates are currently $1.5 billion lower than at the start of price caps, with some $373 million attributable to LEC pricing below the cap. Id. at 9, ¶ 25.

increased LEC earnings indicate only that the price cap plan is largely functioning as the Commission intended.

The earnings growth of LECs subject to price caps has been quite reasonable in light of the business risks facing the LECs and should be little cause for concern to the Commission. For example, LEC earnings are quite reasonable when compared to the interstate earnings of AT&T.[70/]

The ability of price cap carriers to increase their earnings while reducing their prices produces the "win-win" situation for the carriers and their customers that price cap regulation was designed to achieve. As a conceptual matter, however, looking to LEC regulated earnings as a measure of price cap success or failure undercuts the theory of price caps (in the same manner as the Commission's retention of an earnings sharing mechanism) by overlaying upon it a quite different and incompatible regulatory construct. Indeed, using regulated LEC earnings as a measure of reasonableness of LEC profits under price caps (or of LEC productivity in general) is misleading because regulated LEC earnings are overstated in several different respects. First, LEC earnings are overstated because the Commission continues to prescribe inadequate depreciation rates that do not reflect the rapid obsolescence of high-tech equipment.[71/] Consequently, amounts that should be considered returns of investor-supplied capital are instead reflected as additional LEC earnings. Second, reported

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70/ AT&T's annual Interstate Rate of Return Reports since it began price cap regulation reflect the following:

YEAR	TOTAL INTERSTATE RATE OF RETURN
1990	13.73%
1991	13.41%
1992	12.77%
1993	13.48%

71/ See SPR Vision Paper at 39 (observing that "underdepreciation of LEC plant amounts to a huge sum," and concluding that in order to put the LEC industry "on the same sound footing" as other unregulated high-tech firms, regulators would need to authorize approximately $25 billion of depreciation).

interstate earnings are overstated because the Commission has prescribed a rate base that is below the level of prudently invested capital. Third, the Commission has adopted numerous rules that require LECs to understate their costs and/or overstate their revenues vis a vis nonregulated firms in the name of "ratepayer protection." These requirements all serve to artificially inflate the earnings reported by the LECs on their "regulated" books.

As an illustration of the potential magnitude of the overstatement of reported earnings, BellSouth has recalculated its rate of return using the more liberal depreciation treatment accorded to AT&T under the Commission's rules.[72/] As the charts at the end of this section illustrate, when this exercise is performed, BellSouth's earned rate of return for 1991 drops from 12.6% to 8.0%. For 1992, BellSouth's recalculated rate of return falls from 12.8% to 9.9%. For 1993, BellSouth's rate of return falls from 13.7% to 10.2%. These figures not only underscore the reasonableness of LEC earnings under price caps, but also the dangers of relying on rate of return-based earnings calculations to backstop a system of incentive regulation.

A comparison between the depreciation rates prescribed by the Commission for BellSouth and those actually requested by the carrier further illustrates this point. The Commission has recognized the depreciation rates deemed appropriate by carrier management in its regulation of AT&T, the other interexchange carriers, wireless carriers, smaller LECs, and cable television companies.[73/] Indeed, of the various carriers subject to the

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72/ BellSouth does not suggest that the depreciation rates prescribed for AT&T are appropriate for it or any other LEC. The point is that reported accounting earnings are highly dependent on a myriad of underlying regulatory decisions and may vary significantly from economic reality.

73/ Cable television companies depreciate their fiber optic cable over a period of five to fifteen years. Center for Telecommunications Management of the University of Southern California, "Telecommunications Infrastructure Policy and Performance: A Global Perspective" (Jan. 6, 1993). By contrast, the Commission prescribes average depreciation lives for fiber optic cable of more than thirty years for the largest LECs. In the Matter of Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Comments of BellSouth (March 10, 1993), at 10. In its recent cable television ratemaking order, the Commission determined that it would monitor, but not prescribe, the

Commission's regulatory jurisdiction, the Commission only actively controls the depreciation rates of the largest LECs. Unlike the other carriers it oversees, the Commission has consistently prescribed depreciation rates for the large LECs that are much lower than those proposed by the carriers. For example, had the Commission permitted BellSouth to book the depreciation rates deemed appropriate by BellSouth management for 1992, BellSouth's reported earnings of 12.8% would have declined to 11.4%. BellSouth's 1992 reported earnings were inflated by a total of 140 basis points simply because the Commission substituted its judgment for carrier management as to the appropriate rate to depreciate BellSouth's plant and equipment.[74/]

Understated depreciation rates are not the only regulatory device employed by the Commission that distort LEC earnings. The Commission has adopted rate base rules that refuse to recognize hundreds of millions of dollars of capital prudently invested in plant and equipment used and useful in providing regulated service;[75/] has adopted rules regarding the allocation of costs between regulated and nonregulated activities that assign a higher proportion of costs to nonregulated activities than are justified based solely on economics in order to provide additional benefit to ratepayers;[76/] and has adopted affiliate transaction rules that include asymmetrical asset transfer rules specifically designed to favor regulated

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depreciation rates used by cable television companies in cost of service showings. The Commission found the prescription of depreciation rates for cable companies to be "unnecessary." In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service, MM Docket No. 93-155, CS Docket No. 94-28, Report and Order and Further Notice of Proposed Rulemaking, (released Mar. 30, 1994), at 77, ¶ 133.

74/ For 1993, BellSouth's 13.7% reported earned rate of return would fall to 12.0% when re-calculated under BellSouth's proposed depreciation rates. These recalculations are also reflected in the charts located at the end of BellSouth's response to this baseline issue.

75/ See, e.g., Illinois Bell Telephone Co. v. FCC, 911 F.2d 776 (D.C. Cir. 1990).

76/ See, e.g., 47 C.F.R. § 64.901.

carriers (and their ratepayers) in transactions with nonregulated affiliates.[77] While these rules may have been justified as necessary to protect ratepayers under rate of return regulation, they simply serve in a price cap environment to inflate regulated earnings and thereby distort comparisons with the earnings of nonregulated firms. The Commission should recognize these distortions when it evaluates the level of reported LEC earnings for reasonableness.

The Commission has concluded that in order for the profit incentives of price caps to work properly, the LEC productivity factor should not be used as a vehicle to recapture all LEC profits.[78] BellSouth agrees. LEC profits have not risen excessively, especially when appropriate levels of depreciation are factored in as discussed above. To the contrary, LEC earnings merely reflect the proper operation of the Commission's initial price cap plan that is now in need of further refinement. As LECs face the challenges of expanding competition, the Commission should take further steps to purify the LEC price cap plan by eliminating the earnings sharing mechanism and other features of the plan that artificially and unnecessarily inhibit LEC efficiency.

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[77] See 47 C.F.R. § 32.37.

[78] Id.

BELLSOUTH INTERSTATE RETURN

	BellSouth Reported	at AT&T Depreciation Rate	at BellSouth Proposed Depreciation Rates
1991	12.6%	8.0%	n / a
1992	12.8%	9.9%	11.4%
1993	13.7%	10.2%	12.0%